IS THE FEDERAL CORPORATION TAX AN INTERFERENCE WITH THE SOVEREIGNTY OF THE STATES?

AMONG the many arguments with which the constitutionality of the recently enacted Federal Corporation Tax has been assailed is the ingenious suggestion that it is an invasion of the sovereignty of the states.[1] It is urged that "Congress cannot tax the means and instrumentalities employed by the states in exercising their powers and functions any more than a state can tax the instrumentalities similarly employed by the general government," and that "the right to grant articles of incorporation is an attribute of sovereignty belonging to the states, not to the general government." From this line of reasoning is deduced the conclusion that a tax imposed by Congress upon the exercise of the corporate franchise is an interference with the sovereignty of the state granting the franchise and is therefore unconstitutional. By some it has been assumed that the reasoning of that argument was indubitable in itself, and that the answer to it was to be found in its omission to consider the bearing of the federal government's power of regulation of interstate commerce and the power of taxation incident thereto.[2] But ought we not to examine the steps of the argument with a great deal of care before it is sought to maintain the constitutionality of the Act in any such indirect method as by an appeal to the interstate commerce clause?

By the first clause of section 8 of article 1 of the Constitution the Congress is given "power to lay and collect taxes, duties, imposts and excises, to pay the debts and provide for the common defense and general welfare of the United States." The only express qualification or limitation found in the Constitution on the power to levy excise taxes which this clause confers is that contained in the same clause, that "all duties, imposts and excises shall be uniform throughout the United States." There is no other *express* limitation on the

[1] See article by Charles W. Pierson, Outlook, Vol. 93, p. 639 (Nov. 20, 1909).

[2] See editorial comment upon Mr. Pierson's article, Outlook, Vol. 93, p. 622 (Nov. 20, 1909).

power of the national government to levy license or excise taxes.[1] The only limitation which has been *implied* by the construction of the courts is that the Congress shall not, in the exercise of the power, prevent or hamper the states in the discharge of their ordinary functions of government.[2] The power being general and the implied limitation being for a specific purpose, to protect the states from an interference with the machinery of their governments, the limitation must not be carried by implication beyond its purpose. Does not the argument against the Federal Corporation Tax as an invasion of state sovereignty involve such an extension of the limitation beyond its object?

That argument must, in the last analysis, rest upon the proposition that the power of the state to create the artificial entity we call a "corporation" is so essential a part of the means and instrumentalities of the state government that any tax in respect of such entity on the part of the federal government is to be regarded as impliedly beyond the general power of the national government to levy excise taxes. This proposition may well be questioned, both on principle and authority.

The creation of the ordinary corporation by the state does not, in substance, involve a grant by the state to the individuals who constitute the corporation of anything more than the right to do the contemplated business, with an exemption from such a personal liability as they would be under if they were to do the same business as partners, and with the further right of continuing the business regardless of the death of any of them. It is true, they are given the right to do the business in the name of the artificial entity, with a resultant right to sue and liability to be sued in the name of this entity. The power to transfer freely the various shares or interests in the business, by means of transfers of shares of the corporation, is also an incidental advantage of the corporate method over that of the partnership. But there is nothing of substance in these incidental matters. The real objects sought and obtained by means of the incorporation are the immunity from the full personal liability which would follow their embarkation upon the enterprise as partners, and the continuity of the business. These privileges or rights are what the state really gives when it grants the right to do business as a corporation.

Is it not irrational to conclude that the right or power of the state

[1] So. Car. *v.* U. S., 199 U. S 437, 451. [2] *Ibid.*

to accord such privileges as this grant of a corporate franchise proves to be on analysis, is such an inherent and essential part of its governmental functions as to be impliedly protected from any possible incidental effect upon it through the exercise of power given the federal government to levy excise taxes? Whatever may be said of those corporations to which the state grants an integral portion of the public powers or property, given it for the purposes of government itself, such as eminent domain or the right to run a railroad in a street (and of these corporations we shall have a word to say later), it seems perfectly manifest that the state's grant of permission to John Smith, Jacob Jones and myself and our successors to make and sell butter firkins as the "Smith Butter Firkin Co." without a personal liability on any of us for the debts we contract in the enterprise, is not the exercise of such a governmental function as requires the Supreme Court to exempt it from the comprehensive powers of taxation contained in the national Constitution.

The argument under discussion seems to be constructed upon the theory that anything which the state does by way of the creation or regulation of rights in the exercise of its sovereignty, is within the implied limitation upon the nation's general taxing power. This cannot be so, for, carried to its logical conclusion, it would destroy entirely the grant of power to the federal government to levy *any* excise taxes. For example, there can be no shadow of doubt that our right of inheritance, and the right to direct by will how our property shall go after death, are accorded us by the state in the exercise of its sovereignty. Such rights are also entirely regulated by the state. Indeed, the Supreme Court, in sustaining the validity of a state's inheritance tax in respect of a decedent's estate consisting in part of United States bonds, expressly maintained it upon the theory that it was not a tax on the bonds but one on the right of succession, namely, "upon rights and privileges *created* and regulated by the state," [1] or (as otherwise expressed in the same opinion) "rights *derived from* and regulated by the state." [2] The principle upon which the various inheritance taxes or death duties of the states have been upheld, is that, inasmuch as the state has *given* us the right to will property and to inherit, it can carve out of the gift whatever it wishes to retain for itself.[3] Yet a federal inheritance tax has been

[1] Plummer *v.* Coler, 178 U. S. 115, 135.
[2] *Ibid.*, p. 137.
[3] Matter of Estate of Swift, 137 N. Y. 77, 84.

held to be within the power of the Congress, by a decision of the Supreme Court unanimous on this point.[1] The same contention was made in that case, in respect of the state's right to grant and regulate the devolution of property upon death, as is now made concerning the state's right to grant and regulate the incorporation of companies. But Mr. Justice White answers the contention most ably in these words:[2]

"But the fallacy which underlies the proposition contended for is the assumption that the tax on the transmission or receipt of property occasioned by death is imposed on the exclusive power of the state to regulate the devolution of property upon death. The thing forming the universal subject of taxation upon which inheritance and legacy taxes rest is the transmission or receipt, and not the right existing to regulate."

The learned judge then goes on to demonstrate that if the nation or the state were to be denied the right to levy taxes in respect of objects subject to exclusive regulation by the other, many acknowledged objects of taxation would be withdrawn from each, concluding with this forceful demonstration:[3]

"Conveyances, mortgages, leases, pledges, and, indeed, all property and the contracts which arise from its ownership, are subject more or less to state regulation, exclusive in its nature. If the proposition here contended for be sound, such property or dealings in relation thereto cannot be taxed by Congress, even in the form of a stamp duty."

Paraphrasing Judge White's language first quoted, the Corporation Tax is "not upon the state's exclusive right to create and regulate corporations, but upon the *exercise* by the corporation, of the right, when granted, to do business in the corporate capacity." In other words, the state's right to create and regulate the corporation is not taxed or interfered with; the nation only says to the corporation: "If you do business in this artificial, corporate capacity, you must pay this special excise tax to the federal authorities."

It will not do to retort that this incidentally affects and reduces the desirability of incorporation. Precisely that argument was made as militating against the power of the states to tax a devolution on death where the estate consisted in part of United States bonds.[4] It

[1] Knowlton *v.* Moore, 178 U. S. 41.
[2] *Ibid.*, p. 59.
[3] *Ibid.*, pp. 59–60.
[4] Plummer *v.* Coler, 178 U. S. 115, 135.

was argued that such a tax "would operate as a burden upon the borrowing power of the United States." But the court held that any such incidental effect could not be deemed of such importance as to warrant a declaration of want of power in the state to lay the tax in question.

There are some *obiter* remarks in the case of California *v.* Central Pacific Railroad Co.[1] which are not consonant with the views heretofore advanced in this article. These were quoted in the argument under discussion.[2] The court held in that case that the state could not tax the franchises granted to the Central Pacific Railroad Co. by the United States; and, in defining "franchises" and giving examples of them, Mr. Justice Bradley said:[3] "No persons can make themselves a body corporate and politic without legislative authority. Corporate capacity is a franchise." But the fact was that the Central Pacific Railroad Co. got the right to construct most of its line from the charter granted it by the national government. And the decision, consequently, was that the state could not tax that right which the nation had given. "Franchise" has two meanings: (1) the right to build and operate a railroad (and so to exercise the power of eminent domain), and (2) the mere right to be a corporation. One of the ablest judges of the New York Court of Appeals has called attention to this duality in delivering a very recent decision of that court, in these words:[4]

"It is unquestionably true that the franchise to construct and operate a railroad is different from the franchise to be a corporation."

And another able judge of the same court elaborates the distinction in these words:[5]

"The charter of a corporation is the law which gives it existence as such. That is its general franchise which can be repealed at the will of the legislature. A special franchise is the right, granted by the public, to use public property for a public use, but with private profit, such as the right to build and operate a railroad in the streets of a city."

When either the state or the nation gives to any person or corporation the essentially governmental right of eminent domain, it may

[1] 127 U. S. 1. [2] Outlook, Vol. 93, p. 941 (Nov. 20, 1909).
[3] Cal. *v.* Cent. Pac. R. R. Co., 127 U. S. 41.
[4] City of N. Y. *v.* Bryan, 196 N. Y. 158, 163, Cullen, Ch. J.
[5] Lord *v.* Eq. Life Assur. Soc., 194 N. Y. 212, 225, Vann, J.

well be that the grant is to be regarded as one of the "means and instrumentalities employed by the state (or the nation) in the discharge of its ordinary functions as a government," [1] since the government in such a case uses the person or corporation as a depository of one of the governmental powers put into the government's hands for the benefit of all its citizens. But any immunity from taxation accorded to such a corporation rests, not on the franchise to be a corporation, but rather upon the franchise to build and operate the railroad. The exercise of the latter franchise is not dependent upon the corporate franchise, — indeed, it is quite independent of it, for the franchise to construct and run a railroad may be granted to individuals.[2]

Thus, the decision in the Central Pacific case does not furnish any support to the argument against the power of the Congress to levy an excise tax in respect of doing business as a corporation. Furthermore, it must also be noted, in estimating the effect of that case as a precedent, that the transcontinental railroads (of which the Central Pacific was one) were peculiarly governmental and national in character; they were rendered possible only by the active aid and participation of the federal government. In view of these considerations, it will not do to infer from this *obiter* remark of the court, giving an illustration of a "franchise," that the Supreme Court is going to hold that every grant of a franchise to be a corporation is to be placed in the same category as the franchise to build and operate a railroad, which was the "franchise" involved in the Central Pacific case. Indeed, the doctrine of the later decisions, to which attention has been called, seems to indicate the contrary.

The scope of this article does not permit a review of the cases in which federal taxes have been held invalid on account of interference with state activities or functions; but Mr. Justice Brewer sums them up in so recent an authority as South Carolina *v.* United States, as follows: [3]

"It is also worthy of remark that the cases in which the invalidity of a federal tax has been affirmed were those in which the tax was attempted to be levied upon property belonging to the state, or one of its municipalities, or was a charge upon the means and instrumentalities employed by the state, in the discharge of its ordinary functions as a government."

[1] So. Car. *v.* U. S., 199 U. S. 437, 459.
[2] Village of Phœnix *v.* Gannon, 195 N. Y. 471.
[3] 199 U. S. 437, at p. 459.

Nor is it possible, within reasonable bounds of space, to set forth the cases where federal taxes in respect of rights created and regulated by the state have been upheld. The federal "Death Duties" case [1] has been mentioned. Of course, the Spreckels case [2] involves the same proposition, because the state certainly has the exclusive power of regulating the businesses conducted within its borders (apart from the federal interstate commerce power, and the tax under consideration in that case was not based or supported upon that power). South Carolina *v.* United States [3] and the License Tax Cases [4] uphold the power of the federal government to levy a license tax on the sale of liquor. In the South Carolina case, the tax was upheld even where the state itself was doing the business. In the License Tax Cases it was expressly held that the power and right of the states to tax, control, or regulate any business was not inconsistent with the power of Congress to tax such business for national purposes. In Nicol *v.* Ames [5] a federal stamp tax in respect of each sale or agreement to sell any products or merchandise at an exchange was upheld. It surely is self-evident that the regulation of such sales is exclusively within the power of the state. Almost all of the stamp taxes which the federal government has imposed from time to time have been in respect of objects within the exclusive regulation of the states. Take, for instance, the stamp required on deeds and mortgages. Of course, the regulations as to the transfer of real property are peculiarly within the exclusive jurisdiction of the state. Yet no one has ever even asserted a want of power in the federal government to levy such taxes.

When we consider the broad, general grant of power to the national government to levy excise taxes, and the decisions and reasoning which have led to and construed an implication of a limitation on it in favor of the "means and instrumentalities employed by the state in the discharge of its ordinary functions as a government," are we not forced to conclude that this present "tax upon the privilege of doing business in a corporate capacity," as it has been denominated, is not open to attack along the line suggested?

It is denominated a "special excise tax" in the Act itself. In view of this and the remarks of the Supreme Court in the Spreckels case: [6]

[1] Knowlton *v.* Moore, 178 U. S. 41.

[2] Spreckels Sugar Refining Co. *v.* McClain, 192 U. S. 397.

[3] 199 U. S. 437. [4] 5 Wall. 462. [5] 173 U. S. 509.

[6] Spreckels Sugar Refining Co. *v.* McClain, 192 U. S. 397, at p. 411.

"The tax is defined in the act as 'a special excise tax,' and, therefore, it must be assumed, for what it is worth, that Congress had no purpose to exceed its powers under the Constitution, but only to exercise the authority granted to it of laying and collecting excises,"

it would seem difficult to attack the Corporation Tax as something other than what it is legislatively declared to be, notwithstanding the frank avowal of its framers and sponsors that its object was not so much revenue as to bring the corporations under the federal eye and control. Possibly this latter object is within that provision of the first clause of section 8 of article 1 of the Constitution which allows the levying of excises "for the common defense and general welfare of the United States," but it certainly presents some novel aspects. If the *ejusdem generis* principle of construction is applied, the words last quoted would have to be linked to the prior words "to pay the debts," and the whole clause be construed as conferring power to provide only *financial* means "for the common defense and general welfare." But this is a matter quite distinct from the contention that the tax in question is invalid as a clog on the states' "means and instrumentalities of government," and should receive separate consideration.

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